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In the Supreme Court

OF THE

United States

OCTOBER TERM, 1937

No. 388

BANKLINE OIL COMPANY (a corporation),
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR WRIT OF CERTIORARI
to the United States Circuit Court of Appeals
for the Ninth Circuit
and
BRIEF IN SUPPORT THEREOF.

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COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR WRIT OF CERTIORARI
to the United States Circuit Court of Appeals for the Ninth Circuit.

To the Honorable Charles Evans Hughes, Chief Justice of the United States, and to the Associate Justices of the Supreme Court of the United States:

Your petitioner respectfully submits the following:

(a) STATEMENT OF THE MATTER INVOLVED:

The question here involved is whether petitioner is obligated to pay income taxes to the United States,

under Sections 12 and 22 of the Revenue Act of 1928, upon income derived by it from property owned by the State of California and leased by said state to petitioner upon a royalty basis.

(b) **REASONS RELIED ON FOR ALLOWANCE OF THE WRIT:**

In rendering its opinion in the instant case, the Circuit Court of Appeals refused to follow the case of *Burnet v. Coronado Oil & Gas Co.,* 285 U. S. 393, in which this Court held such income was exempt from federal income tax.

It is the contention of petitioner that the facts in the instant case are virtually identical with the facts in *Burnet v. Coronado,* supra.

The Circuit Court of Appeals, in refusing to follow the principle established in the *Coronado* case, but, on the contrary, holding that income received from operations upon a state tideland lease is taxable, committed error.

The Circuit Court of Appeals based its decision against petitioner upon *Burnet v. Jergins Trust,* 288 U. S. 508, which petitioner contends did not involve a situation at all comparable to the instant case.

A concise statement of the case and an argument in support of this petition are contained in the supporting brief. In that brief both of the cases referred to are discussed at length.

Wherefore petitioner respectfully prays that this Court will issue a writ of certiorari to the Circuit

Court of Appeals for the Ninth Circuit in order that the judgment of that Court in this case may be reviewed and corrected.

Dated, San Francisco, California,
September 3, 1937.

A. L. WEIL,
Counsel for Petitioner.

MARTIN J. WEIL,
Of Counsel.

CERTIFICATE OF COUNSEL.

I hereby certify that I am of counsel for petitioner in the above entitled cause and that in my judgment the foregoing petition is well founded in point of law as well as in fact and that said petition is not interposed for delay.

Dated, San Francisco, California,
September 3, 1937.

A. L. WEIL,
Of Counsel for Petitioner.

In the Supreme Court
OF THE
United States

OCTOBER TERM, 1937

No.

BANKLINE OIL COMPANY (a corporation),
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

BRIEF IN SUPPORT OF PETITION FOR WRIT OF CERTIORARI.

STATEMENT DISCLOSING BASIS OF JURISDICTION.

(a) The statutory provision sustaining the jurisdiction of this Court to allow the writ of certiorari prayed for is contained in Section 240 of the Judicial Code. See also United States Code Annotated, Title 28, Section 347.

(b) The decision and order of the United States Board of Tax Appeals in the above entitled matter was made and entered on March 28, 1936.

(c) The opinion of the Circuit Court of Appeals was rendered and filed on June 7, 1937. To date it has not been reported, but a copy thereof is set forth in the appendix attached to this brief.

(d) No petition for a rehearing by the Circuit Court of Appeals was filed.

(e) In the opinion of counsel for petitioner, the judgment of the Circuit Court of Appeals upon that portion of the case which was decided adversely to the Commissioner of Internal Revenue, is not a final judgment.

Simmons Co. v. Grier, 258 U. S. 82;
Louisiana Navigation Co. v. Oyster Commission, 226 U. S. 99;
Keystone Manganese Co. v. Martin, 132 U. S. 91.

Counsel believes that the expressed policy of this Court against hearing cases piecemeal may preclude it from granting either petition in the instant case.

Arnold v. U. S., 263 U. S. 427;
Collins v. Miller, 252 U. S. 364.

However, due to the fact that the questions here involved are not in any way connected, but are entirely separate and distinct, and that the decision upon the portion of the case involved in this petition is unquestionably final, counsel believes that possibly this Court may desire to take jurisdiction of the cause at the present time to avoid further protraction of the litigation.

U. S. v. River Rouge Improvement Co., 269 U. S. 411;
Spiller v. A. T. & Santa Fe Ry. Co., 253 U. S. 117;
American Construction Co. v. Jacksonville, etc. Ry., 148 U. S. 372.

STATEMENT OF THE CASE.

This action was instituted by petitioner in the United States Board of Tax Appeals for the recovery of certain overpayments in income tax made by petitioner for the calendar years 1927, 1928 and 1930. It involved two entirely separate and unrelated questions.

In so far as the question involved in this petition is concerned, the suit was brought for the recovery of income taxes charged against petitioner for the year 1930 upon income derived by petitioner from an oil and gas lease from the State of California. Petitioner claimed that that portion of its income was exempt from taxation, but the Board of Tax Appeals ruled that it was taxable. The Circuit Court of Appeals affirmed the judgment against petitioner.

In another portion of the case petitioner claimed the right to an allowance for depletion upon certain contracts made by petitioner for the extraction of casinghead gasoline from wet gas produced from oil wells. The Circuit Court of Appeals held that petitioner was entitled to such a deduction. It reversed the judgment of the Board of Tax Appeals to the contrary and remanded the case to the Board to find the amount of depletion which petitioner was entitled to deduct. We were advised that the Commissioner is applying for certiorari from that decision. However, in this brief we will confine ourselves to a discussion of the question first set forth.

THE FACTS.

The facts applicable to the particular question involved in this petition are entirely without dispute. In fact, they were the subject of a stipulation entered into between counsel for petitioner and counsel for the Commissioner of Internal Revenue prior to the hearing before the Board of Tax Appeals.

On October 22, 1929, the State of California leased certain oil and gas lands pursuant to Chapter 303, Statutes of California, 1921, approved May 21, 1921, entitled "An Act to Reserve all Minerals in State Lands, etc.", situated in the County of Santa Barbara, Santa Barbara, California, to H. J. Barneson, reserving to itself royalty. The lease covered lands situated below the high tide line, and is known as Lease No. 89, or the Elwood Lease.

The statute referred to provides in Section 4 for the issuance of prospecting permits. Section 5 of the Act provides that a permittee, upon establishing to the satisfaction of the Surveyor General that oil and gas in commercial quantities has been discovered on the permit lands, shall be entitled to a lease on the lands embraced in the permit. The section further provides that

> "such lease shall be for a term of twenty years upon a royalty of five per centum in amount or value of the production * * *"

The Act also provided that prior to the issuance of a lease the lessee

> "shall pay to the State of California twenty per centum of the gross value of all oil or gas secured

by him from the lands embraced within this permit * * *"

At the time of the issuance of the lease, Barneson was a vice-president and director of petitioner and was acting on its behalf in acquiring the lease. On November 14, 1929, Barneson and his wife assigned all of their right, title and interest to the lease to Bankline Oil Company. This assignment was approved by the State of California on December 19, 1929.

On acquiring the lease, petitioner immediately commenced drilling operations. Those operations were successful and resulted in the discovery of oil which petitioner produced during all of 1930. During 1930 its net income as a result of the production from Lease No. 89 was $139,014.28.

SPECIFICATION OF ERROR.

Your petitioner respectfully submits that the Circuit Court of Appeals committed error in refusing to follow the decision of this Court in *Burnet v. Coronado Oil & Gas Co.*, 285 U. S. 393, and in determining that the income of petitioner as the lessee of oil and gas lands from the State of California was subject to taxation under the Revenue Act of 1928.

ARGUMENT.

In support of its contention petitioner presents the following propositions of law:

1. A tax upon the income of a lessee of state tidelands, under an oil and gas lease reserving a royalty to the state, is a tax upon an instrumentality of the state and is therefore improper.

2. The State of California holds its tidelands in a governmental capacity in trust for the benefit of the general public.

3. This Court in deciding *Burnet v. Jergins Trust,* 288 U. S. 508, did not, and did not intend to, overrule its decision in *Burnet v. Coronado Oil & Gas Co.,* 285 U. S. 283.

I.

A TAX UPON APPELLANT'S INCOME FROM LEASE NO. 89 IS A TAX UPON AN INSTRUMENTALITY OF THE STATE OF CALIFORNIA AND IS UNCONSTITUTIONAL.

One of the primary principles, upon which the Constitution of the United States was founded, was that there should be a division of powers between the United States on the one hand and the several sovereign states on the other. In order to carry out that principles, it was established very early in our judicial history that neither a state nor the United States could tax the property or the governmental agencies or instrumentalities of the other.

McCulloch v. Maryland, 4 Wheat. 316;

Weston v. Charleston, 2 Pet. 449;

The Collector v. Day, 11 Wall. 113;
Northwestern Mutual Life Insurance Co. v. Wisconsin, 275 U. S. 136;
Macallen Co. v. Massachusetts, 279 U. S. 620;
Indian Motorcycle Co. v. United States, 283 U. S. 570.

This rule is based upon the principle that a tax by the United States on one of the instrumentalities of the state is a direct burden upon, and an interference with, the state's exercise of its sovereign powers. That such interference exists when the income of a lessee under an oil and gas lease from a state is subjected to federal income taxes was recognized by the Supreme Court in

Burnet v. Coronado Oil & Gas Co., 285 U. S. 393, 400,

a case virtually identical to the instant case. The State of Oklahoma had issued an oil and gas lease to the Coronado Oil & Gas Co. The United States sought to levy an income tax upon the income derived by the Coronado Oil & Gas Co. from that lease. The Supreme Court held that that portion of the company's income that was received from the state lease was exempt from taxation, saying:

> "When Oklahoma undertook to lease her public lands for the benefit of the public schools she exercised a function strictly governmental in character. * * *
>
> "Here the lease to the respondent was an instrumentality of the State for the purpose of carrying out her duty in respect of public schools. To tax the income of the lessee arising therefrom

would amount to an imposition upon the lease itself."

Gillespie v. Oklahoma, 257 U. S. 501;
Indian Territory Illuminating Oil Co. v. Oklahoma, 240 U. S. 522;
Chocktaw v. Harrison, 235 U. S. 292.

In order to induce a person or a corporation to prospect lands for oil, a landowner must offer his prospective lessee an opportunity to make a reasonable profit from his operations, should they be successful. The drilling of oil wells, particularly on tidelands, is a very expensive proposition. The risk is great, for there is always the possibility that a well will be dry, in which event the entire investment is lost. Consequently no person would undertake such a venture unless he was assured that, if his efforts were crowned with success, he would make a sufficient profit to compensate him for the risk involved. One of the important elements considered by a prospective lessee who is trying to estimate his possible return on a particular lease, is the amount of royalties he will have to pay to his landowner.

The exemption from taxation of the profits derived from oil operations on state lands has a direct bearing upon the amount of royalties which the state as landowner can exact from its lessees. If the income of the state's lessee is exempt from federal income taxes, the state would be in a position to charge its lessees a higher royalty than it could otherwise collect. Economically the lessee could afford to increase the royalty paid to the state by the amount which he would

otherwise be required to pay as income taxes. To put it in another way, if the state's lessee were required to pay income taxes to the United States, his ultimate margin of profit, out of which his royalties would be paid, would be reduced. The amount of royalties he could afford to pay would be similarly reduced.

> *Gillespie v. Oklahoma,* 257 U. S. 501, 506.
>
> "The same considerations that invalidate a tax upon the lease invalidate a tax upon the profits of the lease; and, stopping short of theoretical possibilities, a tax upon such profits is a direct hamper upon the effort of the United States to make the best terms that it can for its wards."

Thus it is apparent that the tax, sought to be imposed upon petitioner as lessee of Lease No. 89 from the State of California, is a direct imposition upon the lease itself. That lease being an instrumentality of the state, the tax imposes a burden upon that instrumentality, and is therefore an unconstitutional levy.

> *Burnet v. Coronado Oil & Gas Co.,* 285 U. S. 393.

II.

THE STATE OF CALIFORNIA HOLDS ITS TIDELANDS IN A GOVERNMENTAL CAPACITY.

When the original thirteen states joined together to form the Union, title to tidelands was reserved to them. Similarly, when California was admitted to the Union title to the tidelands bordering on its shores

passed from the United States, which had held them since they were acquired from Mexico, to the state.

Borax Consolidated v. City of Los Angeles, 296 U. S. 10.

Those lands are held by the state in trust for the benefit of the people.

Illinois Central Railroad Co. v. Illinois, 146 U. S. 387.

This Court, in referring to the lands under the navigable water of Lake Michigan, said:

> "But it is a title different in character from that which the state holds in lands intended for sale. It is different from the title which the United States hold in the public lands which are open to pre-emption and sale. It is a title held in trust for the people of the state." (p. 452.)

And a little later, on page 453, referring to the disposal of these lands, they continued:

> "Such abdication is not consistent with the exercise of that trust which requires the government of the state to preserve such waters for the use of the public. The trust devolving upon the state for the public, and which can only be discharged by the management and control of property in which the public has an interest, cannot be relinquished by a transfer of the property. The control of the state for the purposes of the trust can never be lost. * * *"

Heckman v. Swett, 99 Cal. 303.

> "Navigable streams and the shores to ordinary high-water mark are held by the state in trust for the public;"

Ward v. Mulford, 32 Cal. 365, 372.

"The land which the state holds by virtue of her sovereignty, as is well understood, is such as is covered and uncovered by the flow and ebb of the neap of ordinary tides. Such land is held by the state in trust and for the benefit of the people."

See also:

Oakland v. E. K. Wood Lumber Co., 211 Cal. 16, 23;

Boone v. Kingsbury, 206 Cal. 148;

People v. Goldrun Mining Co., 66 Cal. 138, 151.

Inasmuch as the foregoing rule is a rule of property in California, the Federal Courts will follow the rule as adopted by the courts of California.

United States v. Mission Rock Co., 189 U. S. 391.

While the state may dispose of its property to private individuals, it can only do so when the use to which the individual proposes to put the property is for the benefit of, and not inconsistent with, the public trust on which the property is held by the state.

Weber v. State Harbor Commissioners, 18 Wall. 57;

Boone v. Kingsbury, 206 Cal. 148;

Forestier v. Johnson, 164 Cal. 24;

Heckman v. Swett, 99 Cal. 303;

Taylor v. Underhill, 40 Cal. 471.

In

Boone v. Kingsbury, supra,

the California Supreme Court had under consideration the constitutionality of the very act under which

Lease No. 89 was granted. They held that the granting of leases to state tidelands would not affect in any way the title of the state and would not alter its trust relationship, saying, on page 182:

> "The license or privilege authorizing the permittee to prospect and mine tide-lands is denominated by the act a lease, but in practical effect *it strongly partakes of the character of a contract to prospect or mine said tide-lands on a share or percentage basis.* In no sense does the state part with title to its tide-lands. * * *"
>
> "The license or privilege or leasehold by which the permittees are granted the right to explore and mine for gas and oil does not constitute a grant or sale of tide-lands in the sense that those terms are used in the prohibitory provisions of article XV, section 3, state constitution."

and again on page 193:

> "In concluding, it may be helpful to observe that Florida, Texas, Louisiana, Oklahoma, and other states have adopted statutes strikingly similar to our statute, in recognition of the public benefit that will accrue to the commonwealth by the developing of the phosphates, gas, oil and other mineral wealth which lie beneath submerged lands."

If any confirmation of the fact that the state while granting the leases to tidelands still held those lands in its sovereign capacity in trust for the benefit of the public, that confirmation appears from the act itself.

Section 19 of the State Leasing Act provides that all monies received as a result of the leasing of tide-

lands "shall be deposited in the 'general fund'." (1921 Stat., Chap. 303.)

We submit that no valid distinction can be drawn between the status of the Oklahoma leases and the California leases. Can it be said that a state which uses revenues from oil leases for school purposes holds the property in its governmental capacity, while one which holds property in trust for the benefit of the public and turns the revenues derived from the leasing of the same into its general fund does not? The similarity is even more apparent in the case of California, where the monies for public schools are a first lien on the general fund.

> Constitution, Article XIII, Section 15.
>
> "Out of the revenue from State taxes for which provision is made in this article, together with all other State revenues, there shall first be set apart the moneys to be applied by the State to the support of the public school system and the State university."

III.

THE AUTHORITIES CITED BY THE CIRCUIT COURT OF APPEALS DO NOT SUPPORT ITS DECISION.

The Circuit Court of Appeals in rendering its decision relied primarily on

Burnet v. Jergins Trust, 288 U. S. 508, 515, 516.

In that case the City of Long Beach, California, had given Jergins an oil and gas lease on property which it had acquired for a proprietary purpose, namely, for the purpose of securing a water supply. The Court

held that the income received by Jergins was taxable, saying:

> "It was there pointed out that while in one aspect the extent of the exemption must finally depend upon the effect of the tax upon the functions of the government alleged to be affected, still the nature of the governmental agencies and the mode of their constitution may not be disregarded in passing upon the question of tax exemption. An agency may be so intimately connected with the exercise of a power or the performance of a duty by the government that any taxation of it would be a direct interference with the functions of government itself. * * *
>
> "We think that in the present instance *the subject of the tax is so remote from any governmental function* as to render the effect of the exaction inconsiderable as respects the activities of the city. Compare Alward v. Johnson, 282 U. S. 509, 514, 75 L. Ed. 496, 499, 51 S. Ct. 273, 75 A. L. R. 9. Its collection is not inconsistent with and does not trench upon the immunity of the state as a sovereign. The income of the respondent from the lease is not immune from federal income tax."

We will readily concede that oil operations, conducted on land held by a city in a proprietary capacity, are only remotely connected with the performance of an essential governmental function by that city.

South Pasadena v. Pasadena Land and Water Co., 152 Cal. 579,

where the Court said:

> "In administering a public utility, such as a water system, even within its own limits, a city

does not act in its governmental capacity, but in a proprietary and only quasi-public capacity."

Marin Water Co. v. Sausalito, 168 Cal. 587;
Morrison v. Smith Bros., Inc., 211 Cal. 36;
Nourse v. City of Los Angeles, 25 Cal. App. 384.

A municipality, acting in a proprietary capacity, stands on an entirely different basis than when it is performing a governmental function. It loses its sovereign immunity, may be sued without its consent, and is even liable for its torts. In short, it stands in a position very much like that of a private corporation.

The City of Long Beach did not hold its lands in any sovereign capacity or as a trustee as did the United States in *Gillespie v. Oklahoma,* supra, or the state in *Burnet v. Coronado,* supra, and in the instant case.

The Court also referred to

Group No. 1 Oil Corporation v. Bass, 283 U. S. 279,

as authority for its decision. We submit that that decision cannot be considered as a precedent in the instant case. Under Texas law an oil and gas lease is considered as a sale of the oil in place, while in California and Oklahoma a lessee acquires only a profit *a prendre,* or a right to remove the oil.

The distinction was recognized by this Court in

Burnet v. Coronado, supra,

where they said, at page 399, after referring to the *Bass* case:

"As there distinctly indicated, the exemption claimed by the Oil Corporation was denied be-

cause under the settled rule applied by the Texas Supreme Court the oil and gas from disposal of which the corporate income arose had been purchased, not obtained under lease—title had passed out of the State by a present sale. Status of the title was matter for determination under the laws of the State as construed and applied by her courts. In the present cause there is no basis for saying that according to the local law, the transaction between the State and the lessee amounted to a sale."

Similarly there is no basis for saying that the lease from the State of California to Bankline Oil Company amounted to a sale of the oil in place.

Boone v. Kingsbury, 206 Cal. 148, 182.

"The license or privilege or leasehold by which the permittees are granted the right to explore and mine for gas and oil does not constitute a grant or sale of tidelands."

Callahan v. Martin, 3 Cal. (2d) 110, 118.

"We are of the view that an operating lessee under a lease for a term of years, or for a term of years and so long as oil shall be produced in paying quantities, has an interest or estate in real property in the nature of a profit a prendre, which is an incorporeal hereditament."

See also:

Bandini Petroleum Co. v. Superior Court, 110 Cal. App. 123, aff. 284 U. S. 8;

Dabney v. Edwards, 5 Cal. (2d) 1;

Dabney-Johnston Oil Corp. v. Walden, 4 Cal. (2d) 637;

People v. Associated Oil Co., 211 Cal. 93.

CONCLUSION.

In conclusion we submit again that the present case is not distinguishable from *Burnet v. Coronado Oil & Gas Co.* In both cases the state held the leased lands in a governmental capacity and as a trustee for some public purpose.

To exempt the income of a lessee of the State of Oklahoma from federal income tax, and at the same time to levy a tax upon the income of a lessee of the State of California, would be a travesty on justice.

For the reasons set forth, we respectfully submit that the writ of certiorari prayed for by petitioner herein should be granted.

Dated, San Francisco, California,
September 3, 1937.

Respectfully submitted,
A. L. WEIL,
Counsel for Petitioner.

MARTIN J. WEIL,
Of Counsel.

(Appendix Follows.)

Appendix

In the United States Circuit Court of Appeals for the Ninth Circuit

Bankline Oil Company (a corporation), Petitioner, vs. Commissioner of Internal Revenue, Respondent.	No. 8294 Jun. 7, 1937

On Petition to Review an Order of the United States Board of Tax Appeals.

Before: Wilbur, Mathews and Haney, Circuit Judges.

Wilbur, Circuit Judge:

This is a petition for the review of decisions of the United States Board of Tax Appeals entered March 24, 1936 and March 28, 1936 determining a deficiency in petitioners' income taxes of $5,108.71 for the year 1927, of which $3,592.88 has been paid leaving a deficiency of $1,515.83, and a deficiency of $846.94 for the year 1930, of which $825.33 has been paid leaving a deficiency of $21.61, and that there was an overpayment of $65.59 for the year 1928. Petitioner contends that the Board of Tax Appeals should have reduced the deficiency for 1927 by the sum of $2,713.50 and should have determined that there was an overpayment for the year 1928 of $3,598.04 and for the year

1930 of $18,828.04. Petitioner seeks exemption during the taxable year 1930 of all income derived from tide lands situated in the county of Santa Barbara, California, which were leased to petitioner (Note 1) by the state of California for the purpose of producing oil and gas therefrom. Petitioner also claims that the Board erroneously refused to allow it deductions for the years 1927, 1928 and 1930 to which it was entitled because of depletion on its "casinghead gasoline contracts".

As to petitioner's first claim of exemption based upon its income derived from state tide lands:

The State of California holds the tide lands within its boundaries in its sovereign capacity in trust "for the people of the state that they may enjoy the navigation of the waters, carry on commerce over them and have the liberty of fishing therein free from interference of private parties". (Boone v. Kingsbury, 206 Cal. 148, 183. See Constitution of California, Art. 15; Illinois Central R.R.Co. v. Illinois, 146 U.S. 387, see also Rose's U. S. Notes; Borax, Ltd. v. Los Angeles, 296 U.S. 10; Heckman v. Swett, 99 Cal. 303; Oakland v. Buttau, 219 Cal. 745.) The petitioner's lease was granted pursuant to Statutes of California, 1921, ch. 303, p. 404, entitled, "An Act to reserve all minerals in state lands", etc. By this Act, the State has reserved the mineral deposits in all lands belonging to the State

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(Note 1):
By "lease No. 89", the State of California on October 22, 1929, leased the property in question to J. H. Barneson, vice-president and director of petitioner, who acted as agents for petitioner. On November 14th Barneson and his wife assigned all their interest in the lease to petitioner, and on December 19, 1929 the assignment was approved by the State of California.

except lands acquired on a sale for delinquent taxes, unless the deed is required to be filed in the surveyor general's office.

The statute provides for the issuance of prospecting permits (§4). Section 5 of the Act provides that a permittee upon establishing to the satisfaction of the surveyor general that valuable deposits of oil or gas have been discovered within the limits of the land covered by the permit shall be entitled to a lease for one-fourth of the land embraced in the prospecting permit, provided that the permittee shall be granted a lease for as much as one hundred sixty acres. It is provided that "such lease shall be for a term of twenty years upon a royalty of five per centum in amount or value of the production and the annual payment in advance of a rental of one dollar per acre, the rental paid for any one year to be credited against the royalties as they accrue for that year * * *."

Section 6 of the Act provides: "Until the permittee shall apply for lease to the one quarter of the permit area * * * he shall pay to the State of California twenty per centum of the gross value of all oil or gas secured by him from the lands embraced within his permit * * *."

Section 8 of the Act provides for the leasing of unappropriated deposits of oil or gas within the known geologic structure of a producing oil or gas field to the highest bidder, the leases "to be conditioned upon the payment by the lessee of such bonus as may be accepted and of such royalty as may be fixed in the lease, which shall not be less than twelve and one-half per

centum in amount or value of the production, and the payment in advance of a rental of not less than one dollar per acre per annum thereafter during the continuance of the lease, the rental paid for any one year to be credited against the royalties as they accrue for that year".

Section 19 provides: "All moneys received by the surveyor general under the provisions of this act from rents, fees, bonuses and royalties accruing from the use of state school land shall be paid into the 'school fund', all other moneys received under the provisions of this act shall be deposited in the 'general fund'."

One of the purposes of the aforesaid act (Cal. Stat. 1921, ch. 303, p. 404, supra) is to give to the citizens of the state of California, "an opportunity to intercept the large volumes of oil gravitating seaward to inextricable depths, and to reduce to useful purposes oil, gas and mineral depoits reposing beneath the ocean's bed." (Boone v. Kingsbury, 206 Cal. 148, 181, supra.) It was enacted in pursuance of the policy of the State of California "with respect to the extraction of its minerals from state lands", (Boone v. Kingsbury, p. 185, supra). The legislation was upheld by the California Supreme Court against the claim that it violated the implied trust under which the state holds its tide lands because the rights granted by the leases do not interfere with such trust, and do not impair the power of succeeding legislatures to "regulate, protect, improve or develop the public rights of navigation and fishing". (Boone v. Kingsbury, p. 183, supra.)

The federal income tax is not levied on the land so held in trust, nor upon the income of the state derived from the lease of the lands. We are unable to distinguish the situation here from the principle announced by the Supreme Court in Burnet v. Jergins Trust, 288 U.S. 508, where it, in a case involving a tax upon the income derived by a lessee from city owned oil lands held that "the subject of the tax is so remote from any governmental function as to render the effect of the exaction inconsiderable as respect the activities of the city". Mr. Justice Roberts, speaking for the Supreme Court, said:

> "The Revenue Acts do not discriminate between the respondent [lessee] and others similarly situated, in the imposition of the income tax. If the respondent is exempt from the exaction the conclusion must follow because the tax directly burdens the functions of the state acting through the city of Long Beach. Considerations which have led to the condemnation of taxes in other circumstances are here absent. The levy is not upon the property of the municipality, nor upon the income it derives from its property, is not upon the city's share of the oil recovered, the lease, or the gross income therefrom. The law measures the assessment by the net income of the respondent, whose operations are carried on in a private and not in a public capacity for the personal gain of its cestuis ques trustent."

See also, Group No. 1 Oil Corp. v. Bass, 283 U.S. 279.

Petitioner contends that the decision of the Supreme Court in Burnet v. Jergins Trust, supra, is in-

applicable to the case at bar because the lands which were the subject matter of the oil and gas lease in that case had been acquired by the city for the purpose of securing a water supply, and that in operating water works for its inhabitants a city is not exercising its governmental functions. But in Brush v. Commissioner of Internal Revenue, decided by the Supreme Court March 15, 1937, the Supreme Court held that "the acquisition and distribution of a supply of water for the needs of the modern city involve the exercise of essential governmental functions".

On the argument the petitioner attempted to distinguish the situation in the case at bar from that involved in Burnet v. Jergins Trust, supra, on the ground that there the court was dealing with the functions of a municipality of the state while here the state executed the lease in question. This distinction does not seem to be recognized by the authorities which hold that the city, while exercising its governmental functions, is exercising a part of the sovereign power of the state. If so, there can be no distinction in principle between such functions as exercised by the city and by the state. It has been held by the Supreme Court that where the state operates in a proprietary rather than in a governmental capacity its activities are subject to taxation by the federal government. (South Carolina v. U.S., 199 U.S. 437.) It has recently been held in United States v. California, 297 U.S. 175, that where a state is operating in its proprietary, rather than its governmental, capacity it can be penalized by the federal government for violation of federal statute.

We do not place our decision upon the proposition that the state in extracting oil from lands held by it by virtue of sovereignty is acting in a proprietary capacity, particularly where the revenue derived therefrom is utilized in carrying on the governmental functions of the state. The general fund of the state "consists of money received into the treasury and not specifically appropriated to any other fund". (Cal. P. C. §454.) Moneys are disbursed from this fund for public purposes in pursuance of appropriations made by the state legislature. We do not undertake to say whether or not the state is acting in a governmental or proprietary capacity in thus utilizing its state lands. What we do hold is that the tenant who had procured a lease upon such lands for his own profit is liable to taxation upon the net income which he derives therefrom, notwithstanding the fact that his tax liability may tend in some degree to reduce the sum which would otherwise be paid to the state as consideration for the lease. We held to the contrary in Jergins Trust Co. v. Comm'r., 61 F. (2d) 92, relying upon decisions by the Supreme Court in Burnet v. Coronado Oil & Gas Co., 285 U.S. 393; Gillespie v. Oklahoma, 257 U.S. 501; Group No. 1 Oil Corp. v. Bass, 283 U.S. 279. That decision was reversed by the Supreme Court (Jergins v. Comm'r., 288 U.S. 508). The cases which we then cited are now presented by the petitioner in support of its contention that its income derived from the lease of state owned lands is not taxable. We think this case may be distinguished from Burnet v. Coronado Oil & Gas Co., 285 U.S. 393, supra, on the ground that in that case the land and the

oil content thereof had been dedicated by the federal government for school purposes and that the lessee of this land was in effect an agent of the state in applying the proceeds derived from such land to school purposes while in the case at bar there is no restriction upon the right of the state to the use of the moneys derived from the oil lands.

Petitioner's second contention is that it is entitled to an allowance for depletion on its "casinghead gasoline contracts" (Note 2) under the provisions of sections 234 subd. (a)(8), 204 subd. (c)(2), of the Revenue Act of 1926 (44 Stat. 41, 16), and similar provisions contained in the Revenue Act of 1928. (§§23, 114, 45 Stat. 799, 821.)

Petitioner is entitled to a depletion allowance regardless of the technical ownership of the wet gas in place or of the particular legal designation of its interest if by its contracts it obtained an "economic interest" in the gas in place. (Palmer v. Bender, 287 U.S. 551; Helvering v. Falk, 291 U.S. 183; Lynch v. Alworth Stephens Co., 267 U.S. 364; United States v. Biwabik Mining Co., 247 U.S. 116; Signal Gasoline Corp., v. Comm'r., 66 F.(2d) 886; Obispo Oil Co. v. Welch, decided by this court September 28, 1936.)

The rights of petitioner under the "casinghead contracts" on which it seeks a depletion allowance are substantially the same in all the contracts. In these

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(Note 2):

One contract was made by petitioner June 9, 1922 with General Petroleum Corporation.

Three of these contracts were entered into by petitioner on October 25, 1923 with the United Oil Company, one on May 22, 1925 with the Superior Oil Company, and one on October 9, 1928 with the Richfield Oil Company, and are entirely distinct from the state tide land leases considered above.

contracts it was provided that petitioner was entitled to receive for the purpose of extracting gasoline therefrom all the gas produced (with exceptions on some contracts) on the properties of the producers covered by the agreement. The producers agreed to deliver the gas at casingheads or gas traps installed by them on their premises. Petitioner agreed to furnish, install and maintain all pipe lines and connections from the casingheads or gas traps to its plant, and to pay the producers thirty-three and one-third per cent of the total gross proceeds derived from the sale of gasoline extracted from wet gas or at the producer's option, thirty-three and one-third per cent of the gasoline extracted. It was agreed that after the use by petitioner of as much dry gas as it might require for plant operations, and after deductions for waste, not to exceed certain percentages of the gas the producers were entitled to the remaining dry gas.

In Signal Gasoline Corp., v. Comm'r., 66 F.(2d) 886, supra, we held that the taxpayer who had a right to wet gas produced under contracts similar to those in the case at bar had an economic interest in the oil in place entitling it to a depletion allowance. Respondent contends that the contracts in the case at bar are distinguishable from those involved in Signal Gasoline Corp., v. Comm'r., supra; that in that case there was valuable consideration given for the contracts whereas in the case at bar no consideration was given for the contracts. He claims that in Signal Gasoline Corp., v. Comm'r., supra, there were provisions in the contracts there involved requiring the taxpayer to participate in the production of the gas

while in the case at bar the petitioner incurred no obligations in connection with the production of the gas and the production was always controlled by the producer.

The ultimate question to be determined, however, is whether the taxpayer claiming a depletion allowance has an "economic interest" in the oil or gas in place in the properties. It has such an interest if it is entitled to a part of the oil or gas produced from the properties as a part of its capital. (Palmer v. Bender, supra; Helvering v. Falk, supra; Signal Gasoline Corp. v. Comm'r., supra, p. 890; Obispo Oil Co. v. Welch, supra.)

In the majority opinion the Board concluded that the taxpayer in the instant case had no depletable interest in the gas in place. In distinguishing the instant case from the Signal Gasoline Corp. v. Comm'r., 66 F.(2d) 886, it said:

"The court there was convinced that the contracts under consideration and the 'methods employed in reducing the wet gas to possession' created 'an interest in the gas in place or a right to share in the gas produced'. It concluded that the petitioner has the 'requisite economic interest which under the statute entitled it to reasonable allowances for depletion'. We are not so convinced."

This was too narrow a view of what constitutes an economic interest in the oil and gas. Three members of the Board concurred in the result upon the ground that "petitioner has failed to show that the value of wet gas at the mouth of the well purchased under

casinghead gasoline contracts was in excess of the royalties paid therefor and therefore has not shown any proper basis for depletion deductions. Signal Gasoline Corporation, 30 B.T.A. 568, Affd. C.C.A. 9th Cir. 77 F.(2d) 778; Lomita Gasoline Co., 33 B.T.A. 385. * * * Petitioner's failure of proof to show what amount of depletion deductions, if any, it is entitled to take, appears to be similar to that in the cases above cited."

We have heretofore considered the extent of the depletable base of a taxpayer in an oil and gas well. In pursuance of our decision in Signal Gasoline Corp. v. Comm'r., 66 F.(2d) 886, the Board of Tax Appeals, 30 B.T.A. 568, in carrying out the mandate of this court, held that for the purpose of determining the depletion allowance the gross income from the oil property of the manufacturer who produced gasoline from wet gas was the difference between the market value of the wet gas delivered to it less the amount the manufacturer had agreed to pay for it. In dealing with that subject the Board of Tax Appeals said:

"It is well established that a taxpayer may not claim the benefit of a deduction which the statute grants to another. Dalton v. Bowers, 287 U.S. 404; Burnet v. Clark, 287 U.S. 410; Burnet v. Commonwealth Improvement Co., 287 U.S. 415. It follows that the gross income of the lessee from the same production, if any, must be the excess of the fair market value of the wet gas as and when received, over the royalties which it pays under the contracts. * * *

"If the fair market value of wet gas when received by the lessee is not greater than the royalties which it

pays, there is no income of any kind from its property in the leases and, consequently, no gross income that can be used as a basis for computing depletion. In the circumstances herein the petitioner must show that when received by it the wet gas had a fair market value in excess of royalties paid to the lessors. This it has failed to do, and in the absence of such showing we must assume that the fair market value of the wet gas was not in excess of the royalties paid."

This decision correctly states the rule. It was affirmed in Gasoline Corp. v. Comm'r., 77 F.(2d) 728.

Petitioner offered evidence showing that in the tax years in question, the prevailing rate of royalties paid by other refiners of wet gas was higher than that paid by petitioner under its contracts. J. Lee Cross, for over twenty years in the business of making contracts for gasoline and leases with land owners, testified that the prevailing rates of royalty paid on the gasoline extracted from wet gas by casinghead companies in 1927 was 45%, in 1928 47½% and in 1930 50%. T. L. Taggart, contract superintendent of the Standard Gasoline Company whose duty with that company was to make gas processing contracts, testified that the royalty paid in 1927 was 43%, in 1928 45%, and in 1930 47%. John McFarland, in charge of the contract department of the Gilmore Oil Company, testified that the royalty paid in 1927 was 45%, in 1928 50%, and in 1930 50%. F. K. Baxter, witness for respondent, and engineer revenue agent with the Internal Revenue Bureau, testified:

"There is no question but the royalty rate increased from 1923 to 1928. In 1923 there were more at 33⅓%

than there were at less than 33⅓%. That was the usual rate in 1923—33⅓%. Gradually the rate has increased, as has been testified to here, and up to 37½% and 40 to 45 and up to 50."

Respondent contends in his brief, however, that "a rise in royalty rates does not establish the value of petitioner's wet gas at the mouth of the well, and certainly does not prove that the value of the interest acquired exceeded what petitioner had to pay for it", that "in proving comparatives it must be shown that the basis of comparison is the same"; that petitioner failed to put in evidence any of the contracts of any other producers in the same field which contracts might have contained provisions different from petitioner's and justifying the refiner in paying a higher rate of royalty. Respondent contends, for example, that the contracts used for comparison may have contained no provision for the return of dry gas to the producer. He further contends that petitioner "failed to prove that the prevailing rates were upon wells producing the same gasoline content as the wells in petitioner's contracts", that the royalty rate would be higher on a well producing gas of a high gasoline content, than on one producing gas of a low gasoline content.

In establishing a rise in the market price of wet gas petitioner was forced to rely on prevailing royalty rates under contracts similar to the contracts in the case at bar for it is clear from the record that in California wet gas is not sold for a price per unit at the mouth of the well. It is apparent from the testimony that the contracts used as a basis of comparison by

the witnesses who testified to the rise in the prevailing royalty may be sufficiently similar to petitioner's contracts to make their testimony a fair criterion by which to determine whether petitioner under its contracts had a right to gas below its market value.

J. Lee Cross testified:

> "I know about the operation of a casinghead gas plant, and I made contracts similar to those involved in this case.
>
> It is not a fact that there are two general types of contracts. The gasoline company acts the same under all contracts, and assumes all contracts are as one. While firms may have worded them differently, they are operated on exactly the same by all absorption plants. I have worked for pretty nearly half of the absorption plants. I make no distinction in a contract providing for the purchase and sale of gas, and one merely providing for the treatment of it; they are all processing contracts. * * *
>
> Generally the contracts provide that after the extraction of the gasoline, the dry gas is returned to the producer. * * *
>
> I am familiar with the general type of casinghead gas contracts entered into for extraction of gasoline in which the owner of the casinghead plant goes to an operator and says that he would treat his gas for so much royalty."

The testimony of respondent's witness F. K. Baxter is not substantially different from that of Cross. He testified:

> "I am familiar with the types of casinghead contracts used by the various operators. There are several types of those contracts. When I

say type, I mean changes in wording. There is one type which says that the producer agrees to sell and the casinghead man agreed to buy. The other merely provides for the treatment of gas. * * *

In some of the contracts with which I am familiar, the dry gas belongs to the casinghead contractor, while in other cases it belongs to the producer, and is sold under his instructions. * * *

In my experience I found two broad types of contract—the gas treatment and the purchase and sale contract. The casinghead man accounts to the operator of the well for the dry gas sold.

It is usually provided that a substantial part of the dry gas, between 66⅔ and 75%, remains the property of the producer. * * *"

As we have pointed out, the testimony of this witness as well as that of witnesses for petitioner, was that there was a rise in the royalty rates in the years in question. The inference from this testimony is that the contracts upon which they based their conclusion were substantially the same.

As to respondent's contention that the royalty rate paid on a well that produced more gasoline per cubic feet of gas would be higher than on one producing less, it is sufficient to say that there is testimony to the contrary. J. Lee Cross testified on that subject as follows:

"It makes no difference whether the gas is rich or lean, whether you have a half gallon or four or five gallons. The royalty rate is just the same.

Ninety to ninety-five per cent of the extraction contracts are made before the wells are brought in."

In considering the decision of the Board of Tax Appeals under review the contention of the taxpayer may be more succinctly shown by reference to the amounts it claims for depletion. We quote from its brief in that regard as follows:

> "* * * if petitioner's contentions are correct, it is entitled to an allowance for depletion computed in the following manner:

	Value of Gasoline Recovered	Contract Royalty	Prevailing Royalty	Depletable Interest	Depletion
1927	626,494.68	208,831.67	281,922.61	73,090.93	20,100.00
1928	769,633.55	256,544.33	365,575.94	109,031.61	29,983.69
1930	390,596.48	130,257.68	195,298.24	65,040.56	17,886.15
				$247,163.11	67,969.84

In the foregoing statement the petitioner assumes that the evidence has established the values stated as "prevailing royalty" and that such "prevailing royalty" was the market value of the wet gas delivered to it, and that its "depletable interest" amounts in all to $247,163.11 for the three years 1927, 1928 and 1929, which represents the difference between the royalty it had agreed to pay under its contracts referred to as "contract royalty" and the market value of wet gas as established by the "prevailing royalty". The method of establishing values is a fact-finding and not a mathematical process. The Board of Tax Appeals was not obliged to accept the testimony as to the "prevailing royalties" as conclusive evidence of market value. The process of arriving at market value is a judicial process and requires that in weighing the evidence the credibility of witnesses should be considered and that in determining market value there should be an independent exercise of

judgment as to value. It is true that the majority of the Board found that wet gas "as it flows from the earth is not a salable commodity". It does not follow, however, that it does not have a market value because it is invariably purchased by manufacturing concerns under royalty agreements for the production of casing-head gasoline, although it is not sold at a price per unit.

If, for the purpose of determining the taxpayer's gross income from the property, we attempt to fix the difference between the market value of the wet gas and the contract value thereof, we would invade the fact-finding jurisdiction of the Board of Tax Appeals. It is clear that a majority of the Board bases its decision against the taxpayer in part at least upon the ground that the nature of the taxpayer's contract is such that he would not be entitled to depletion, regardless of the question of whether or not its contract is so favorable that there was or may have been a difference between the price paid for wet gas in terms of gasoline and its market value. In this regard we think the majority of the Board erred, and that in the case at bar, having to deal with the contract under which the taxpayer was entitled to all the wet gas produced from the wells so long as any was produced, it should have ascertained whether or not it had any economic interest in the gas in place, and if so the amount of depletion to be allowed.

As we have pointed out the evidence in the case all tends to show that by reason of the change in royalty rates the petitioner had a definite economic interest in the oil in place upon which it was entitled to an allow-

ance for depletion. The extent of that right and the depletion allowance thereon is a question of fact to be determined by the Board of Tax Appeals upon the evidence before it.

In fixing the depletion allowance it is not sufficient to establish the taxpayer's gross income from the property and estimate the depletion allowance at 27½ per cent thereof. It is necessary also for the taxpayer to show that this percentage does not exceed one-half of the net income from the property, unless the taxpayer claims a greater allowance for depletion than one-half of the net income in which event he must establish that it would be more if computed without reference to the two percentages above mentioned. (Par. 2, of §204(c) of the Revenue Act of 1926, 44 Stat. 16.) The record herein does not clearly show that the taxpayer offered evidence as to the net income from the property. It apparently assumed that there was no expense of the taxpayer incident to the production of the wet gas received by it and that the net income and the gross income from the property were identical. The figures it uses in claiming depletion allowance above set forth would so indicate. As this deficiency in the proof was not the basis of the decision by the Board of Tax Appeals we feel that the taxpayer should be accorded the right to supplement its proof on that subject and that the Board of Tax Appeals should make such an allowance for depletion as in its judgment is in accord with the evidence under the law as herein decided.

The decision of the Board is affirmed as to the non-exemption of the income of the petitioner derived from leases of petitioner on state owned tide lands,

and reversed as to the disallowance for depletion on its casinghead gasoline contracts with instructions to allow additional evidence as to depletion, and to fix the allowance in accordance herewith.

Haney, Circuit Judge, concurring.

I concur in that portion of the opinion prepared by Judge Wilbur which affirms a portion of the Board's decision.

I concur in reversal, but I express a substantial doubt that "wet gas", with respect to which the Board found "as it flows from the ground is not a salable commodity", can have a market value.

(Endorsed:) Opinion and Concurring Opinion. Filed Jun. 7, 1937. Paul P. O'Brien, Clerk.